RESEARCH REPORT

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Subject:	Impact of the Constitutional Expenditure Limitation on Long-range Fiscal Planning
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Issue

What is the impact of the Constitutional expenditure limitation on County budgetary and fiscal planning, and what strategies can the County employ to comply with the limitation while maintaining mandated and critical services?

Background

In 1980, voters approved two amendments to the state constitution that were intended to limit future taxing and spending increases by local governments without voter approval. The property tax levy limit (*Article IX, Section 19*) restrains annual increases in the primary property tax levy to 2% on existing property. The expenditure limitation (*Article IX, Section 20*) restrains annual increases in expenditures by counties, cities, towns and community college districts to growth in population and inflation. Expenditure limitations are based on actual spending in FY 1979-80, plus any approved changes.

The expenditure limitation applies to expenditures made from all “local” revenue sources. Generally, local revenues include any taxes or fees levied by the Board of Supervisors, as well as state-shared sales and vehicle license taxes, but exclude grants and contracts with other governments. The limit does not necessarily exclude **mandated** expenditures; generally, if they are derived from local revenues, mandated expenditures are **not** exempt. The Flood Control, Library, and Stadium Districts are not subject to the expenditure limit because they are legally separate entities.

The expenditure limitation can be increased with voter approval. In 1998, the ballot referendum to authorize the Maricopa County jail excise tax was accompanied by a referendum approving an increase in the expenditure limit to allow for increased jail and juvenile detention operating costs. The FY 1979-80 base limit was increased by $15.6 million, which results in an increase of $67.6 million in the FY 1999-00 limit and increases each year thereafter. This increased expenditure limit should not be required until several years from now when the planned facilities become operational.

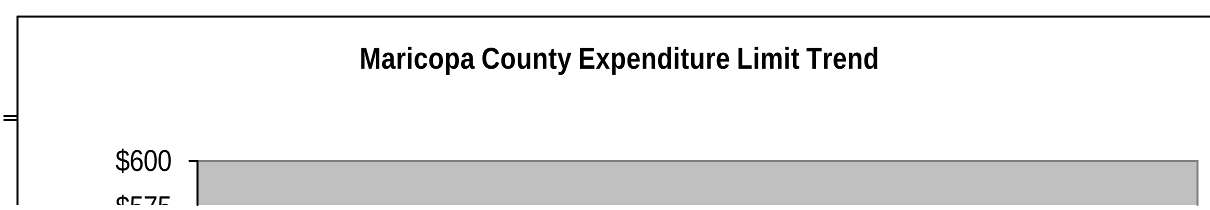
Since FY 1992-93, each year the Legislature has also adjusted Maricopa and Pima County's expenditure limitations to reflect Disproportionate Share payments. The adjustment is made because the mechanics of the Disproportionate Share allocation would allow the County to take an inappropriate double deduction from its expenditures subject to limitation. First, the Disproportionate Share program results in a payment to the county hospital, the full amount of which can be deducted from the county's limited expenditures. Second, a smaller amount is withheld from the county's state sales tax contributions by the state, and this amount is also excluded from limited expenditures.

The Expenditure Limit has not been of pressing concern in Maricopa County up to now because actual spending has been comfortably under the limit since the fiscal crisis of the mid-1990's. In addition, the Maricopa County expenditure limitation will increase for FY 1999-00 with the jail adjustment. However, County spending in the last few years has begun to increase at a faster rate than the expenditure limit. Expenditures have been ramped up to address deferred capital maintenance, market-driven employee compensation increases, and increasing demand for services due to a rapidly growing population, particularly in criminal justice programs. **Without careful planning the additional expenditure authority intended for detention operating costs could be used up by other spending increases by the time the new facilities open**. This report presents an analysis of specific problem areas related to the expenditure limitation and proposes strategies for addressing them.

Discussion

The following chart shows the recent growth trends in the expenditure limitation and actual expenditures subject to limit covering the period of the fiscal crisis and recovery. Since Fiscal Year 1993-94, the expenditure limit has increased from $363 million to $460 million, nearly 27%. While population growth has been high, inflation has been low, resulting in a growth rate of only 5.8% for FY 1998-99, and projected to decrease.

The amount of expenditures less than the limit in each fiscal year can be carried forward for use in future fiscal years. Through FY 1997-98, Maricopa County had accumulated $73.7 million in carry-forward expenditure limit capacity; although the final figures are still being audited, FY 1998-99 actual expenditures will exceed the limit and reduce the carry-forward balance. Expenditures subject to limit have increased as Maricopa County has invested in employee compensation and infrastructure since the fiscal crisis. In addition, the recent practice of financing large capital expenditures with cash has compounded the problem, as discussed below.



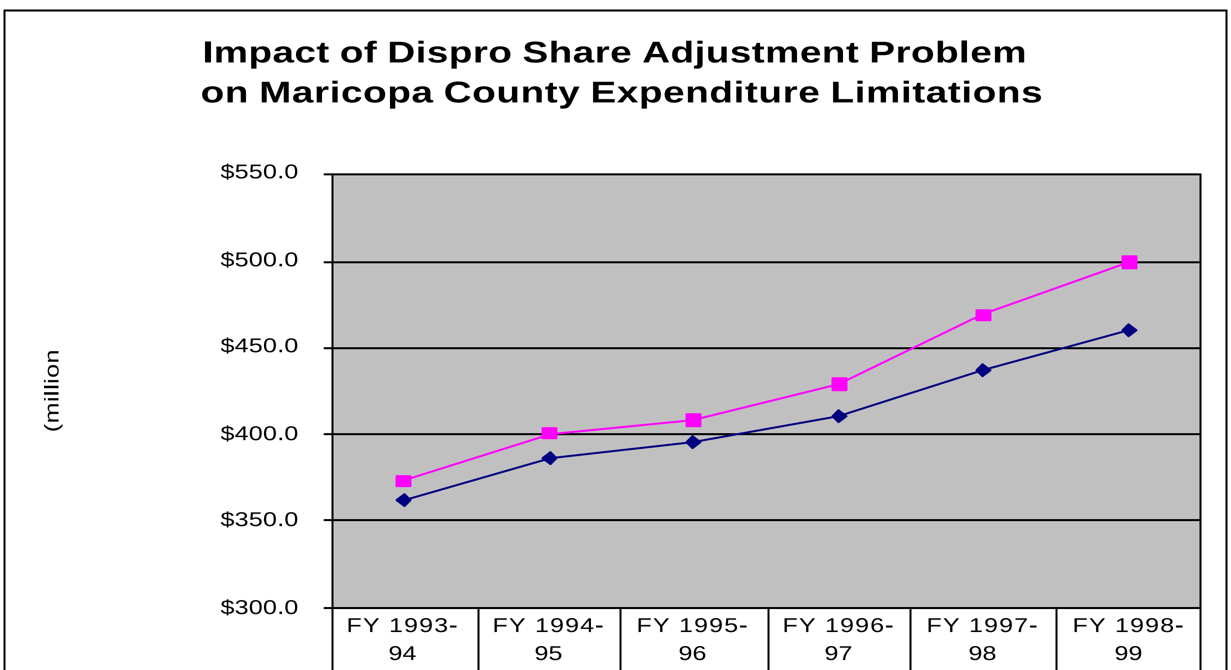
Analysis by the Department of Finance shows how different areas of FY 1998-99 County spending applied to the expenditure limitation. As shown in the following table, the applicable portion of the General Fund makes up most of the expenditures. Nonetheless, the Department of Transportation (MCDOT) and the Integrated Health System (MIHS) also contribute to this issue.

Fund		Amount	%
General Fund	$	326,035,547	69.5%
MMC		57,784,710	12.3%
MCDOT		33,582,588	7.2%
Air Quality Fees		10,027,131	2.1%
Gen. Fund CIP		8,379,478	1.8%
Other Special Revenue		6,813,656	1.5%
Sheriff Special Funds		6,586,981	1.4%
Adult Probation Fees		6,065,292	1.3%
Animal Control		4,724,054	1.0%
Recorder Surcharge		3,946,633	0.8%
Maricopa Health Plans		2,747,382	0.6%
Lake Pleasant		1,301,964	0.3%
Solid Waste/Waste Tire		1,016,525	0.2%
	$	469,011,941	

Problem with Disproportionate Share Adjustment: Our analysis of historical trends in the Maricopa County expenditure limitation revealed a problem with how the Disproportionate

Share adjustment is applied that has inappropriately reduced the limitation amount each year since FY 1993-94. Each fiscal year, the Legislature approves session law that is designed to reduce the following year's expenditure limitation by the amount of gross disproportionate share revenues. In order to make the adjustment, an amount has to be deducted from the 1980 base limit, which is then re-inflated to reflect current population and price levels.

Since FY 1992-93, session law has decreed that the following year's disproportionate share amount will be deflated to its 1980 equivalent using *FY 1991-92* population and inflation data, when the current year's data should be used. As a result, the FY 1998-99 final expenditure limit was set $39.3 million lower than it should have been, and the disparity grows each year. Mathematically, Maricopa and Pima County's expenditure limitations will be reduced to zero eventually, depending how much dispro share payments increase. The following chart displays the difference between the actual expenditure limits with the limits that would have been set had the adjustment been carried out appropriately. It is important to note that, if the adjustment had been applied correctly, Maricopa County's current expenditures would be well under the limitations, but that the carry-forward balance from prior years would also have been significantly greater.



	FY 1993-94	FY 1994-95	FY 1995-96	FY 1996-97	FY 1997-98	FY 1998-99
Current Law	$362.7	$386.7	$394.9	$411.1	$436.6	$460.2
Corrected	$373.0	$400.4	$408.3	$429.9	$468.3	$499.5

ity of the calculation, a likely explanation is that the reference to FY 1991-92 data in the original session law was never updated because of a staff oversight. In any event, the problem can only be corrected through legislative action.

<u>Funding of Major Capital Investments:</u> Expenditures for capital improvement projects and major capital items that are financed by accumulated fund balance are subject to the expenditure limit. However, capital spending can be excluded if the projects or items are funded by debt in the form of bonds, certificates of participation (COP's) or capital leases. Resulting annual debt service expenditures are also excluded from the limit. Capital improvement project spending can also be excluded from the limit if it is funded with revenue set aside in a voter-approved "capital accumulation fund". The capital project fund for the jail and juvenile detention facilities, supported by accumulating revenue from the jail excise tax, is an example of a capital accumulation fund.

Unfortunately, Maricopa County's recent budgetary practice of setting aside General Fund operating surpluses for capital improvement projects is a potential problem because of its impact on the expenditure limit. The short-term increase in spending from fund balance is subject to the expenditure limit, whereas debt financing could be excluded. The $22.5 million allocated in the FY 1999-00 budget for capital projects supported by General Fund balance would count against the expenditure limit this year.

Likewise, the Department of Transportation's (MCDOT's) spending of accumulated fund balance on capital projects also counts against the expenditure limit. MCDOT's Highway User Revenue Fund (HURF) proceeds can be deducted from expenditures in the year they are received (net of HURF received in 1980), but when the funds are not spent but carried forward as fund balance, their expenditure is subject to the limit. For FY 1998-99, MCDOT spending totaling $33.6 million was subject to the limit.

Potential Strategies:

- *Issue COP's to finance capital projects and enter into capital lease-purchases for major capital equipment, while reserving accumulated fund balance for retirement of the debt. This would allow the capital project expenditures and debt service to be excluded from the limit, while effectively insuring that the debt will be repaid with current accumulated resources.*
- *Seek voter approval for a "capital accumulation fund"; this particular remedy may be appropriate for MCDOT.*

<u>Expenditures Supported by Fees and Fines:</u> Fees and fines are treated as local revenue along with taxes under the expenditure limit. Up to now, proposed spending increases supported by significant fee increases, such as last year's increases in Planning and Development and Air Quality, have been considered favorably because they were self-funded and would not impose an additional tax burden. Nonetheless, these initiatives are still subject to the expenditure limit.

Many fees collected by the County, including recording fees and many court fees, are mandated by statute for specific purposes but are treated as local revenue under the expenditure limit. Since the Board of Supervisors does not set these fees, an argument could be made that these revenues are non-local and thus should be excluded from the expenditure limit.

Potential Strategies:

- *Carefully review all budget requests supported by new fees on the same basis as spending from general revenues, considering their impact on the expenditure limitation.*
- *Seek a legal determination that statutory fee funds are not local revenue for purposes of the expenditure limitation.*
- *If statutory fees cannot be excluded, structure such fees so that they are remitted to the State and then allocated to the counties as state grants. This strategy has the potential drawback that Maricopa County would not be guaranteed to receive back all of the funds it collects.*

<u>Maricopa Integrated Health System (MIHS):</u> Although MIHS is an enterprise fund that is supported by fees that it charges for its services, its expenditures are generally only excluded from the limit if they are supported by payments from AHCCCS, Medicare, or another governmental entity. Any MIHS expenditures supported by private sector revenue, such as contracts with private health insurers, are subject to the expenditure limit. Expanding MIHS' business with the private sector will use additional expenditure limit capacity. Even MIHS' HealthSelect spending supported by County employee premiums is subject to the limit. In FY 1998-99, MIHS expenditures of $60.5 million counted against the expenditure limit.

One particular problem is that, while in practice net income from the health plan funds offsets operating losses in the Maricopa Health System fund (MMC and clinics), the full amount of net MHS expenditures are subject to the expenditure limit without being reduced by the net revenue from the health plans. If net revenue from the health plans could counted as non-local revenue for MMC, County expenditures subject to limitation would be reduced by $5-$10 million per year.

Potential Strategies:

- Pursue a method to allow Maricopa Health Plans' net revenue to be counted against Medical Center expenditures for purposes of the expenditure limitation.
- Legally separate MIHS from the County. This could be accomplished by either privatizing the system or establishing it as a legally separate special district. If MIHS were moved to a special district, it is possible that the change would be treated as the transfer of a function and cause our expenditure limitation to be reduced. The County

would still benefit by not having to allocate greater shares of its expenditure limitation growth to MIHS.

Conclusions and Recommendations

This report outlines several areas in which Maricopa County can seek to either increase its expenditure limitation or exclude more expenditures from being subject to the limitation. Nonetheless, the limit itself will remain and will only increase with population growth and inflation. **Once all of the possible remedies are carried out, Maricopa County will still ultimately need to restrain spending growth to the levels allowed by the expenditure limitation unless there is sufficient justification and desire to seek voter approval for an increase in the limitation.**

1. Seek legislative correction to the Disproportionate Share adjustment to the Maricopa and Pima County expenditure limitations.

2. OMB and the Department of Finance should coordinate a more detailed review to identify any additional deductions and exclusions that may not have been used previously.

3. Department budget issue requests should continue to be restricted, as begun for FY 2000-01, and departmental budget recommendations should be developed consistent with the anticipated growth rate in the expenditure limitation. Budget analyses should include identifying which budget issues or other funding increases are subject to the limit, which are not.

4. MCDOT should manage its capital improvement projects in the future to avoid delays that result in funding carry-overs that then count against the expenditure limitation.

5. Funding for capital projects and major capital acquisitions should be financed by Certificates of Participation or capital leases; available fund balance can be set aside and reserved for re-payment of the debt, thereby effectively maintaining the policy of using accumulated fund savings for major capital spending.

6. The County should seek a legal interpretation that allows excluding statutory fees from the expenditures subject to limitation. If such an interpretation cannot be obtained, the County should seek to restructure such fees as state grants to the County.

7. Move to legally separate MIHS from Maricopa County, either through privatization or through creation of a special district.

8. Seek voter approval for “capital accumulation funds” for General Fund – Appropriated Fund Balance and MCDOT.